Forex Outlook August 2012

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Introduction

Welcome to August monthly report from Forex Crunch. July saw another more signs of deterioration in the global economy, with Europe dragging the entire world down. However, the events at the turn of the month may have been the beginning of a real change. August is usually a month of vacations and calm in the markets. Looking at last August's historic downgrade of the US, this year's burning issues in the euro-zone and the never ending speculation about future US moves, another hot August awaits us.

The report discusses the main themes, with Europe still taking most of the focus, as events there impact all currencies.

Specific currency outlooks follow. Each currency outlook consists of two parts: a fundamental overview and a high time-frame technical analysis. A timetable of key events and some extra additional notes for forex traders end the report.

As always, feedback is more than welcome. I'd love to hear your comments at yohay@forexcrunch.com. The plan is to continue with monthly reports.

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Global Themes

Greece making a comeback

After the pro-bailout parties won the elections, Greece was on the back burner during July. However, Greece continues missing its targets and yet another round of tight negotiations is underway, towards a deadline on August 20th.

Greece has a bond repayment to the ECB, in a sum of over 3 billion euros that apparently, it doesn't have. One option is that the ECB will accept a delay in this payment, or even totally write it down.

The ECB made itself exempt from the bond restructuring program that was made in March. In fact, it even made a decent profit on the holdings of Greek debt, as it bought those bonds for a low price in the markets.

ECB president Mario Draghi already said that the profits made from bond holdings could be "redistributed" back to governments. This is his chance. A haircut for the ECB, even if it is covered by nice words such as redistributing profits, could be a very interesting precedent, that would improve market sentiment in two manners:

1. **Seniority**: The fear that bonds held by the ECB would have seniority over bonds held by private factors certainly scared off investors. Why would you invest in peripheral bonds if you are going to be subordinated? Draghi already said that the issue of seniority will be addressed. This is his chance.
2. **Hope for Greece**: Currently, most of Greece's debt is held by the "official sector" – the EFSF bailout fund, the ECB and the IMF, after private bondholders suffered a haircut of nearly 75%. However, the burden on Greece is still huge, and there's no hope for growth after 5 years of recession. Relieving the country's debt by contribution from the official sector would give more hope for the country to return to normality and even stay in the euro-zone.

Nevertheless, the less hopeful scenario is ever present. Greece continues missing targets, also of the second bailout program.

- **Collection of taxes** is a serious issue, and so is the collection of penalties. This alone, costs Greece 12.5 billion euros, more than the recent cuts it announced following the troika's visit. Greeks are also discouraged by the recent scandal involving the former CEO of ATEbank, who transferred his personal wealth abroad – not really a confidence building measure.
- **Fragile coalition**: With every new round of cuts demanded by the troika, the coalition becomes more fragile, and the blame game continues. In the meantime, the opposition is gaining traction. Alexis Tsipras, who wanted to cancel the bailouts, was smart to stay on the sidelines and could win the next elections.
- **Population shrinkage**: The ongoing crisis has long term results that also undermine the country's ability to grow: Greece lost around 3% of its population in the last decade, despite receiving immigration. It's hard to see the economy growing when the population is shrinking.

During July, there have been reports that the IMF is fed up with Greece. These reports could be part of a tactic to push Greece to make more cuts. However, the IMF was reluctant during the whole process. IMF programs usually involve debt restructuring and a devaluation of the currency. Debt restructuring came only in the second bailout program, while currency devaluation is impossible within the euro-zone.

In addition, the IMF is uncomfortable with the slow moves in Europe and the growing prospects of not seeing its loans returning.

The opportunity for the IMF to withdraw its support for Greece appears on every visit by the troika, but the IMF might have a better chance when the ESM (permanent bailout fund) is finally used. This will likely wait at least until September 12th, when the German constitutional court is expected to approve the ESM.

If the IMF indeed withdraws, this could start a rapid domino effect in which Germany, the Netherlands, Finland and Austria also withdraw, and Greece eventually leaves the euro-zone.

It's clear to see that the bailout programs don't work for Greece. Again, it's important to stress that the blame cannot be put only on side.

Only accepting a loss by the official sector could keep Greece in the euro-zone. A first and important step could be taken by Draghi and the ECB regarding the August 20th payment.

If Greece eventually pays the bond repayment using more troika money and implements more austerity measures, the deterioration will likely continue and raise the stakes for the dreaded Grexit as early as September.

Here is how to trade the Grexit with EUR/USD.

King Draghi

The European Central Bank is finally stepping up its efforts to stabilize the euro-zone – at least the countries that are too big to fail: Spain and Italy. ECB president Mario Draghi opened the door to a full QE program: buying bonds in big quantities and not draining out the money out of the markets, as the ECB did so far.

Draghi disappointed by not acting immediately and conditioning the action on formal aid requests, especially from Spain. This is probably in the works already: Spain's PM didn't reject a formal aid request, and just wants to see what the ECB has in store.

A Spanish aid request will probably come in August. Even if the ECB waits for the ESM to come into effect in September, the prospects of bond buying will likely ease the pressure on Spanish bonds. The euro-zone's fourth largest economy will be able to recycle loans at lower costs, and this will be helpful for the euro.

Draghi clearly stated that it will buy short dated bonds, as this is the closest to monetary policy – the ECB sets short term interest rates. There is of course another goal in limiting the bond buying to the short end of the curve: keeping up the pressure on Spain.

Fear of euro breakup

The gap between yields in the north and the south reflected fear of a euro breakup, or "convertibility" in the jargon the ECB.

Massive buying of Spanish bonds by the ECB is a step to preserve the euro (which the ECB prints). Draghi stated that saving the euro is part of the ECB's mandate.

Having a single currency without a single fiscal policy seemed problematic from the very start. However, labor mobility was supposed to provide a solution: instead of transferring money from north to south (a German dreaded transfer union), workers would move quickly and balance the situation: lowering the unemployment in the weaker countries for example.

However, this is very limited according to a recent research by the IMF:

> "Only about 1 per cent of the working age population changes residence within their country in a given year, and even less move between euro area countries. This compares to about 3 per cent in the US, 2 per cent in Australia, and slightly less than 2 per cent in Canada".

So, **intervening to balance borrowing costs is the ECB's way of balancing** and for sending a message that the euro is irreversible.

It is quite remarkable that Draghi managed to convince almost all ECB members to vote for this move. The only reservation is from Germany. The traditional view of Germany is that monetary policy should focus only on battling inflation that Germans fear so much, and that money printing triggers moral hazard.

Nevertheless, also Germany knows that it needs the euro, more than anybody else. German experts estimated that a full breakup of the euro would cost Germany 3 trillion euros.

Bank supervision

A small sweetener that the ECB (and Germany) received is bank supervision. Yet again, this will take time, but the ECB will eventually supervise over banks, similar to central banks' roles in some other countries. This will give the central bank more power to "transmit monetary policy" and have more control in general.

Up to now, bond buys didn't do enough to calm markets, but did raise the question of seniority, like in the Greek restructuring.

The bank supervision is especially important after the episode of the LTRO: the ECB lent cheap money to banks so that they'll buy their governments' respective bonds and enjoy an arbitrage. Not only did the banks lose money as the situation deteriorated, but the links between sovereigns and the banks became even more tight, or "adverse" as the IMF noted.

In Spain, the banks need the state to save them from their losses, and the state needs the banks to buy its bonds. Draghi said that the LTRO was a great success and that it prevented a credit crunch, but it also had significant negative effects.

Bank supervision is a step for detaching the banks from the sovereigns, and it gives the ECB more control if it decides to make another big operation involving the banks.

North European Problems

Contagion doesn't only concern rising bond yields that infect larger Club Med countries after hitting smaller ones, but also trouble in the real economy reaching the core of the core, Germany.

In addition, another strong country, Finland, is flirting with exiting the zone.

Germany is known as an "export machine". Lower demand from Europe, with many countries in recession, is certainly hurting the country. In addition, the slowdown in China also weighs. The result is that Germany's manufacturing sector is squeezing in the fastest speed since 2009: Markit's manufacturing dropped to 43 points. German services are doing a bit better, but this will is likely insufficient from keeping Germany out of contraction.

The German economy enjoyed substantial growth in Q1 – growth that kept the whole euro-zone from contracting and officially entering into a recession. Data for Q2 will be published during August, and will likely point to contraction.

German business indicators continued falling: this was seen in both the early ZEW indicator and the wide IFO survey, which had a tendency of being optimistic, and is falling quite fast. The bad news influence confidence and this in turn hurts the real economy.

While Germany feels the pain of the debt crisis, it is important to stress once again that Germany needs the euro-zone, probably more than any other country.

According to one estimate, Germany makes 12 times in exports than it risks in the ESM, and the euro is 20% undervalued vs the Deutschmark. This definitely helps Germany, which enjoys a trade surplus which is much bigger than the total deficit of all other countries. And, a total euro breakup would inflict a heavy loss to Germany.

Finland looks to the exit

Finland could leave euro zone, hinted the finance minister. She said that Finland will prefer to leave the zone rather than pays the debt of others.

Also other statements are not so supportive: Sayings such as “solidarity has limits” are aimed at the Finnish public who is reluctant to help the southern states. Finland stood out by requesting collateral from Greece and then from Spain, in case the programs fail in these countries.

The Finnish Prime Minister also said that the ESM has preferred creditor status – a preferred status for the ESM, or seniority, is exactly the thing that scared investors after the Greek restructuring. The ECB wants to address the issue of seniority, and Finland is not on the same page.

How real is the threat?

Finland is in the northeast corner of the euro-zone and has a lot of trade with non-euro-zone countries such as Russia, Norway, Sweden and Poland. So, perhaps it doesn't make sense for Finland to "Hang itself to the euro" as they said.

Finland is the euro-zone country with a perfect AAA rating that didn't receive a negative outlook by Moody's. This adds to the confidence of the northern country.

Contrary to Germany, Finland has low costs of leaving the zone, making such a move not only positive for the Finnish population but also not disastrous for the economy.

On the other hand, Finland did approve the recent agreements and its representative in the central bank did support Draghi's conditional QE program and didn't side with Germany on this topic.

It will be interesting to follow Finland's statements and actions during August.

Pain in Spain, Italian Spaghetti

As aforementioned, Spain will likely submit a formal aid request during August, and this will open the door for ECB help. However, Spain doesn't have any more planned bond auctions during this month, and could take its time, before a showdown in September.

If Spain takes its time, this could be very problematic, as the country already faces serious trouble in all parts of the economy. However, there is little room for reforms now, as the **political credit fell together with Spain's credit rating**.

As Spain's PM Mariano Rajoy already admitted more than once, Spanish institutions are shut out of money markets. So while the Spanish government still has access and doesn't need money in August, banks, corporates, regions and municipalities have no mercy from the markets and could lean on the central government.

This could cost Spain with another loss of credit rating – the country is already close to junk status and it will not take much for Spain's bonds to get the junk label.

Money is already leaving Spain at an accelerating pace. The sooner ECB money flows into Spain, the better.

However, support for Europe is eroding in one of the most euro-supportive countries of Europe. First serious call to leave the euro in Spain by Francisco Alvarez Cascos of Asturias called for Spain to leave the euro-zone. Membership in the euro and in Europe is still popular in Spain, which still remembers the isolation during the years of the dictatorship.

Spain now faces difficult tiptoeing between making reforms and cuts (some quite logical) to meet the ECB's demands and lowering yields, and not pushing it too hard on the citizens, which are fed up with broken promises.

For example, the recent announcement about raising the VAT angered many Spaniards, as it came after Rajoy and his partners at the PP repeatedly vowed not to raise it.

Focus on Catalonia

6 Spanish regions may ask for help: Contagion is raging in Spain after Valencia's first move to tap money from the central government's internal bailout fund.

The northeast region of Catalonia is a relatively rich, industrial region which is critical for Spain's finances. Catalonia enjoys more and more cultural autonomy, but tax collection is in the hands of the central government. Many Catalans feel that are subsidizing other parts of Spain with these taxes while receiving less from Madrid. They want to match their status to another northern rich industrial region: the Basque country. Catalan parties had significant achievements in the last general elections.

This is always rejected by the central government that needs the cash. With the deterioration in the economic situation, Catalonia ran out of money, and finds itself asking for money from Spain. This in turn raises more support for the separatists. According to recent polls, support for an independent Catalonia now has passed the 50% mark. If no light will be seen at the end of the tunnel, the demonstrations will culminate in Catalonia's national day, September 11th.

Rajoy's government passed legislation allowing the central government to take over finances of the regions in case of trouble, but limiting Catalan autonomy when there's demand for more will be very problematic, and Rajoy will likely avoid such a step.

Italy looking good only out of the country

Italian Prime Minister toured European capitals with great success, and also managed to move stubborn Germany and other countries to support the European cause.

However, his popularity is falling in his own country. The technocrat PM is scheduled to step down in 2013, but his government may not last that long. Austerity measures are taking a heavy toll on the Italian economy.

The unemployment rate is moving higher, and too fast. It reached 10.8%. The economy shrank at an alarming rate of 0.8% and probably suffered a similar rate in Q2.

- Unions don't like his reforms and plan a general strike in September.
- 10 major Italian cities risk a crash as their finances are strained.
- In addition, Sicily is also struggling to balance its budget. Regional problems in Italy cannot be compared to Spain's, but they add to the mess.

On this background, the anti-euro sentiment is rising. It is currently led by the anti-politicians party of Beppe Grillo, but the sentiment is growing among mainstream politicians as well.

Former Italian PM Silvio Berlusconi, who is out of office for less than a year, is already planning his comeback and also adopted some anti-euro sentiment.

The return of Berlusconi could accelerate a move to bring the elections forward to later this year. Political parties are discussing this.

Similar to Spain, Italy needs ECB money to lower its bond yields, but the political price may be too much.

Chinese Situation Worse But Stimulus on the Way

The world's No. 2 economy cannot ride fast forever. The most recent growth figures raised even bigger doubts that they usually do.

But, the Chinese authorities still have room to stimulate the economy.

The doubts about China's growth come from a growing number of internal and external figures:

- **PMIs**: Both the official PMI and the independent HSBC / Markit figure show that manufacturing is flat – not growing. The unofficial figure is lower. The new orders component is the more worrying part, as it indicates future deterioration.
- **Oil**: The demand for oil fell by 1.9% in June. This is quite surprising in a country that is experiencing rapid growth and an ominous sign.
- **Electricity**: Another source of energy, electricity, also fell. China produced 393.4 billion kilowatt-hours, off slightly from 396.8 billion from the same month last year.
- **Inflation falling**: Not so long ago, China was battling rising prices of food and other products and raised the rates to fight this phenomenon. Recent official figures show that China has inflation under control. This may sound like good news, but it is also a sign of economic slowdown, that probably began in June.
- **Unemployment rising?**: According to somewhat anecdotal evidence, unemployment is rising in China. This could trigger social unrest. However, there is no substantial evidence of employment issues. Not yet.
- **China cut its interest rate at the beginning of July**. Why would they do it if the situation is so good? More cuts in the interest rate and the RRR are likely later this year, and could be seen also in August.

Rebalancing: China is expected to move from an investment / export model to more services, innovation and internal consumption. There are early signs that this may be starting to happen. The process is undoubtedly long. The big questions are: a) if the authorities will push harder for this rebalancing and b) if they are able to do so.

We will probably see more action in August, but an answer to the questions above will probably wait.

It's important to note that China is not the only large emerging economy that is suffering. The troubles in the Indian economy are felt in the value of the rupee, and the global slowdown also in South Africa, that made a surprising rate cut.

The US: Another Hole in Jackson Hole?

The single most important topic that moves the dollar is QE3, or the lack of it. Since QE2 ended in June 2011, the debate is never-ending. Bernanke gave hints for QE2 in August 2010 in Jackson Hole, but didn't repeat it in 2011, disappointing some market participants. Will he pave the road for QE3 now? Probably not.

The recent decision by Bernanke and his colleagues contained no new policy decisions. Those in the QE3 camp saw the worried words in the statement as a preparation for QE3 in September's meeting. However, they seem to miss a simple reality of already low yields.

Are the low yields a result of QE3 hopes? Perhaps, but this is only one of the reasons. The slowdown in China, the deterioration in Europe and the muddy waters of stock markets also help yields stay low.

Housing isn't that bright – but no action coming

Yields are low for the short end of the curve, as well as the long end, which the Fed continues targeting via Operation Twist. Also the 30 year rate for mortgages fell to 3.49% at one point.

So, targeting the housing sector in a new QE program (by buying MBAs) also seems to have little chances.

Another sing that housing doesn't need help comes from house prices. Recent figures have shown that house prices continue rising. This is another sign showing that US housing found a bottom. However, growth from this bottom will likely be limited.

One of the reasons for limited recovery prospects comes from the high burden of student loans. This deters young couples from buying homes.

While prices are moving slowly higher, transactions remain limited. Existing home sales and new home sales aren't really moving higher. Most of the market is existing homes, but new homes have a greater impact on the economy, as they boost home building, which creates jobs and other activity.

While housing remains cautiously optimistic, manufacturing looks a bit pessimistic. The ISM Manufacturing PMI fell for two months in a row, the Philly Fed Index is in negative ground and other figures also look slow.

The most important sector is services, which is around three quarters of the US economy. Here, the picture is also mixed. The PMI was positive, but the job component was negative. Consumer confidence is stable, but not climbing.

So, it is hard for to tell if the economy is struggling and needs help from the Fed. As aforementioned, the Fed has limited tools in terms of QE3.

Jackson Hole

Fed Chairman Ben Bernanke already said that QE programs have "diminishing returns". This was followed by saying that non-standard tools shouldn't be used lightly and that the tools have "some capacity" to help the economy – not very QE3ish.

Bernanke could use the annual Jackson Hole Symposium held at the end of August to float other ideas. One such idea is a program that will help small businesses, although it's unclear what the Fed could do. Two years ago, Bernanke hinted about QE2 at this important meeting.

Another thing Bernanke already did in the past is pass the ball to the politicians' court. He warned about the "fiscal cliff" several times. At the end of the year, many tax programs expire and unless politicians move to extend these programs or introduce new schemes, the US economy will suffer from automatic tax hikes and spending cuts – something that could hurt the economy if everything happens all at once.

It is reasonable to assume that politicians will find some kind of compromise after the elections in November. One of the things that will happen automatically is a cut in the defense budget. Politicians are already working to prevent this from happening, even before the elections.

This is somewhat surprising, as an overwhelming majority of Americans support big cuts in the defense budget.

Bernanke will not get into details about taxes or spending, but will likely warn about this danger, and the current uncertainty, that also inflicts some damage on the economy.

The motivation for QE1 was lowering long term interest rates. The motivation for QE2 was the threat of deflation. Deflation isn't a danger at the moment, especially with recent US droughts and rises in food prices.

But even without deflation, could the Fed strive for higher inflation? More on that below.

Future of Market Impact and Policy

As mentioned beforehand, the Federal Reserve doesn't have many tools to move the economy. Also most other central banks have already tried various conventional and unconventional tools to get out of the crisis. So did governments.

Nearly 4 years after Lehman Brothers collapsed, recovery is slow or nonexistent. The world is still deleveraging from the various bubbles and fighting the Debt Mountains is a Sisyphean task. Perhaps it's time for a different approach?

One way to fight debt is by eroding it – making it worth less – inflating away. An idea that floated for some time but hasn't received much attention is that central banks will target nominal growth instead of real growth.

This is one big step forward from fighting deflation. GDP takes inflation into account. The rise in prices erodes nominal growth. This makes sense. The best thing is to have strong growth with stable prices.

However, in the current situation, the economies are hardly growing, and so are prices. Debt remains high.

So, if you can't have strong real growth, nominal growth could be a substitute. The US economy grew by 1.7% in 2011 and prices rose by 3%. That is a nominal GDP growth rate of around 4.7%.

The Fed stated that an inflation rate of 2% is desired. The ECB has a similar goal.

Instead of targeting inflation as most centrals do, the target could be a high nominal GDP growth rate of 7% for example. Targeting NGDP means disregarding accelerated rises in prices. In real terms, the economy could remain flat, and inflation could run at 7%. The benefit would be fast erosion of debt that isn't linked to inflation.

This is a very unconventional approach, and a total change of doctrine of central banks which are programmed to fight inflation. The US suffered from high inflation in the 70s and underwent a significant recession to lower the accelerated rise in prices.

But was the situation that bad back in the 70s?

Inflation was ugly, yes: 7.4% on average. However, real GDP growth was at 3.3% on average, much better than the 1.5% growth in the 2000s or 2.4% after the crisis began.

Stirring inflation not only erodes debt, but encourages consumption, as consumers see no chance of falling prices.

The problem is that once you let the inflation genie out of the bottle, it is very hard to control it. With the current levels of debt and depression in the Western world, there is a lot of room between controlled inflation + extremely slow growth and raging inflation.

Are policymakers up for such a shift? It's hard to believe that they'll ever admit it or communicate it. However, the recent move by Draghi to announce potential QE despite German opposition, and the potential of QE3 in the US despite having extremely low bond yields means that stimulating or at least tolerating higher inflation is possible policy course.

If Bernanke indeed launches QE3, it will practically target nominal GDP.

Currency Outlooks

This section consists of a fundamental country specific outlook and a high time frame technical analysis for each currency against the US dollar. The situation in the US has already been discussed, so the first part concerning the US dollar is only technical, referring to the US Dollar Index. Also for Europe, see the in-depth fundamental coverage for more.

- All the charts are weekly charts.
- A description on the lines follows each section.
- For shorter term outlooks, please follow the weekly outlooks on Forex Crunch, linked in every section.
- If you prefer to view the charts on a web page, just click on the image.

US Dollar Index – Staying in Uptrend Channel

The US Dollar Index continued trading in a wide uptrend channel since the middle of 2011. It resumed its rises after a correction in June.

Lines

89.62 is the post financial crisis high and is the final frontier on top. 88.70 is another peak, seen in May 2010, when the Greece received the first bailout.

86.87 is a minor line, serving twice as resistance in the early stages of the crisis. 85 is a round number that provided some support when the index was trading at a high level during 2010.

83.50 was the peak of an upwards move in the middle of 2010, before QE2 became reality and is now closer. 81.80 served as support in 2010 and as resistance in early 2012 and now switches to support.

81.12 provided support in June 2012 and also had a minor role as resistance in the past. Above the round number of 80, 80.23 is another important support line that was tackled twice in the spring of 2012, serving as the top border of a tighter range.

The bottom border of this range is 78.59, which was a cushion in April and also in January. 77.50 is the next big support line. It worked as both support and resistance in 2009.

76 capped the long range trading of the pair in 2011 and is strong support. 73.50 was the bottom border of that range.

For the major market movers, see the **[Forex Weekly Outlook]**.

Euro – Looking Better?

See detailed information about Europe in the global themes.

EUR/USD Technical Outlook

The pair had a bad month, to say the least. The very wide channel that begins in 2008 is trending down.

More importantly, the pair continues trading in the steep downtrend channel that began in late 2011 and was formed at the beginning of 2012. This channel is highlighted in the graph, with downtrend resistance being far more important that downtrend support at this time.

Lines

The 2011 peak of 1.4940 is a significant line as well on the upside. 1.4282 was the peak of the surge in November 2010.

The swing low of 1.3838 seen in mid-2010 was also of important at the beginning of 2010 as a cap and as a separator back in 2008. 1.34 is the top border of the sideways range and remains strong despite a temporary breach early in the year.

The round number of 1.30 is not only a psychological line but also strong resistance. It was strong support and its break triggered a big fall. 1.2587 is now minor resistance after the break. It provided support during 2010.

The first post crisis bottom at 1.2330 is no in focus. Despite being an old line, it is of importance. 1.2150 played an important role in May 2010 as a clear separator. It also worked as resistance back in 2006.

1.20 returns to play an important role after the pair got close to it in July 2012. Below 1.20, the 1.1876 bottom seen in 2010 is a very strong line.

The next line is symbolic: 1.17. This the launch price of the euro in 1999. It is closely followed by 1.1670, which was a trough in the middle of the 2000s.

Even lower, important lines are the round numbers, as these levels were visited a long time ago.

For more on the euro, see the **EUR/USD Weekly Outlook**.

British Pound – Clouds are Darkening This Summer

The choppy pound hardly moved against the dollar. One of the factors helping the pound is the Olympic Games. However, the underlying economy is in deep trouble.

The UK experienced a third consecutive quarter of contraction, and this time it was much more severe: 0.7%. The jubilee celebrations and wet weather do not explain the sad situation. Initial indicators for Q3 point to yet another quarter of negative growth. The UK may complete a full year of economic squeeze, and this may be seen in the value of the pound.

- **Austerity backlash**: The tough austerity steps that the British government helped it retain the perfect AAA rating, but the result of austerity, the recession, endangers this status. Currently, British bonds are well supported by flows from the continent and by massive bond buys from the BOE. Nevertheless, without growth, the sacred AAA rating is in danger.
- **Banking backlash**: To be fair, it's not only austerity that hurt the economy, but also the regulators that contributed to contraction via big demands from banks to raise their core capital. The British banking system has quite a few issues, including the latest Liebor scandal, but the strict demands had a negative impact on the economy.
- **Lower inflation opens door to more QE**: In hindsight, the decision to ignore rising inflation and leave monetary stimulus in place proved to be wise, as inflation is now falling on its own, thanks to a drop in commodity prices and the recession. Lower inflation paves the road for more QE in the future. It's important to remember that QE has a short term negative effect on the pound, not a lasting one.
- **Rate cut possible**: Perhaps a bigger blow for the pound could come from another rate cut. The MPC maintained a rate of 0.5% for several years. Although this is already a rock bottom level, a symbolic step to lower the rate is on the cards, and this could weaken the pound, even if the economic implication is minimal.
- **Watch the services sector**: Housing was very problematic in the crisis, to say the least. Nevertheless, the services sector should be closely watched, as it is 77% of the economy, much bigger than any other sectors. A potential recovery could come from this sector, which is still growing, but slowly.

During the Olympic Games, sterling will likely remain relatively strong, trading in range. This may change afterwards.

GBP/USD Technical Outlook

In the bigger scheme of things, pound/dollar traded in a range and eventually stayed in the same place. Looking at an even wider picture, the pair is capped by downtrend resistance.

1.7440 was a stepping stone on the way down during the peak of the crisis. 1.7042 is the post crisis peak reached during 2009 and never sought since. It is right above the round number of 1.70.

Below, 1.6750 was the peak of 2011 and also had a similar role during 2009. 1.63 was a peak in 2010 and later worked as a pivotal line. The failure to break above this level ignited the fall.

The round number of 1.60 also had a significant role in the past, but it is weaker now. The trough of 1.5780 was of high importance in 2011 and also in 2009. It proved its strength as resistance in June 2012.

Quite close by, 1.56 had an important role as a support line in 2012, and it now works as a pivotal line in the current range. The double bottom of 1.5270 seen at the end of 2011 and the beginning of 2012 is the lowest points since 2010 and remains strong.

Below the round number of 1.50, we find 1.48, which provided an important cushion at the beginning of 2010. The bottom of 2010 at 1.4227 is significant on a big downfall. Last but least, we find the post crisis low of 1.3514.

For more on the pound, see the **GBP/USD Weekly Outlook**.

Japanese Yen – Deflation Could Pave Road for Intervention

The Japanese yen made steady gains against the dollar and the euro, enjoying the safe haven status.

The return of Japan to the dreaded deflation justifies an intervention, at least a stealth one. However, Japanese authorities showed their weakness in the past, and it's hard to blame them: fighting the safe haven flow is very hard.

There are various factors moving the yen. The picture is mixed:

- **Deflation**: The fall in prices is sometimes called the "Japanese disease". When an economy stagnates too long, it is "turning Japanese". A constant fall in prices paralyzes the economy. Japan fought very hard to move prices to the upside, but now they are falling again. In order to reach the +1% inflation target, the BOJ might act. Raising the QE program up to 70 trillion yen is discussed in public.
- **Bypassing the dollar**: Japan and China began trading directly with their own currencies, bypassing the dollar that was used for their bilateral transactions so far. Apart from the implications for China, this move could strengthen the yen.
- **Fighting EUR/JPY**: Recent comments show that Japan is not only worried about the strength of the yen against the dollar, but also against the euro. The euro-zone is a significant trade partner.
- **US Indicators**: It's important to note that apart from safe haven flows, USD/JPY reacts in the most "normal" manner to US indicators – rising on

good ones and falling on the disappointing ones. The absence of QE3 in the US plays against the yen.

- **Internal issues**: Apart from deflation, Japan's economy isn't doing too well. A hotly debated sales tax is weighing on the country, as well as energy issues following the catastrophic earthquake, tsunami and nuclear tragedy. In addition, it has a debt mountain that is double its GDP. Nevertheless, these issues don't impact its safe haven status or its currency.

USD/JPY Technical Outlook

Dollar/yen practically reversed the gains and slid lower, but it remained quite stable.

Lines

85.50 was the peak in 2011 after the coordinated intervention. 84.20 is the peak reached and challenged in March 2012.

82.87 was the line where the BOJ intervened in September 2010 and it played a role afterwards as well. It is currently a minor resistance line. The 80.60 line is becoming more notable on the weekly chars, just above the round number of 80. It served in both directions during 2012.

The round number of 80 was strongly guarded for some time and remains of psychological importance. The break below is significant. 78 proved to be more significant support than the older 0.7830 line.

Minor support is at 76.60, which worked as support early in 2012. 76 was a previous all-time low and is now support in the range.

The round number of 75, in uncharted territory might test the patience of the BOJ and the low of 75.57. A failure to guard this line has a potential of throwing the pair towards 70.

For more on the yen, see the **USD/JPY Weekly Outlook**.

Swiss Franc – SNB Stuck in a Big Euro Long Position

In the outlook for July, the risk that the Swiss National Bank has was discussed. The 1.20 floor under EUR/CHF has effectively become a full peg.

However, this doesn't come without a cost. Switzerland wasn't willing or wasn't able to diversify most of its euro acquisitions, and it has a huge EUR long position. This is telling for the euro – it remains weak despite all the Swiss buying.

The SNB pledged to buy foreign currency without limits. Nevertheless, this is gradually becoming a problem, with 60% holdings in euro. Bets are rising for a break of the floor. The SNB will likely use a positive European event to get rid of some of the euros, but in case the debt issues worsen, the pressure on the SNB will rise.

So far, the Swiss managed to retain high credibility and maintain the peg. What can break them? A sharp move that will catch them off guard. In such a case, we will see an avalanche in EUR/CHF and USD/CHF.

Will this happen in August? Probably not. There are higher chances for such a move in September.

USD/CHF Technical Outlook

It's important to note that USD/CHF is practically a mirror of EUR/USD due to the peg. However, it's nice to see that uptrend support is emerging. And, in case the peg falls, these lines will return to their importance.

Lines

1.17 was an important and stubborn peak in 2010 and remains an important cap above. 1.11 worked as support at the end of 2007 and also a cap in 2009 and 2010.

1.09 capped the pair during 2010 and provided support beforehand. 1.0435 was support in 2010 and an area of struggle.

The round number of parity returns to the scene. It is backed by 1.0066. 0.9783 was a double top and provides strong resistance.

The round number of 0.95 worked as support and has psychological importance as well. It is now pivotal. 0.9315 worked recently as resistance and as support beforehand.

0.89, very close by is another significant support line that proved its strength early in the year and also back in 2011. 0.8567 is worth mentioning on the downside. It served as support on the way down and then switched to resistance.

Further below, 0.8330 was a strong line of support. 0.7820 is the final frontier before the big plunge to the all-time low at 0.7066.

For more on the Swiss franc, see the **USD/CHF Weekly Outlook**.

Canadian Dollar – Strong and Stable

The world's No. 10 economy is in a favorable situation, enjoying plausible levels of unemployment and isn't feeling the US slowdown so far.

USD/CAD could settle below parity during August. What moves the C$?

- **Sound economy**: The low unemployment rate, continued growth and relatively low debt all support the loonie.
- **Hawkish central bank**: On this background, the BOC is able to discuss a return to full capacity, even if the forecast was now moved to H2 2013. There is also talk about raising the rates.
- **US Demand**: So far, this has been positive for the US, as its big southern neighbor is still growing. 75% of exports are to the US. A downturn in the US might weigh on the loonie.
- **Safe haven**: Canada enjoys the trust of many countries, including Russia. This comes despite the dependency on the US and the underwhelming debt-to-GDP ratio of 83%. Nevertheless, Canada has a small safe haven status.
- **Oil**: With a major pipeline to the US flowing north to south, it is easier for Canada to export its oil. Never-ending Mid East tensions keep the price of oil relatively high, and this also contributes to the strength of the loonie.
- **Housing Bubble**: Prices in Toronto are of worry to many Canadian officials. It's hard to tell if the situation is under control. This remains a risk factor.

USD/CAD Technical Outlook

USD/CAD had a choppy yet steady fall towards parity. Note the downtrend channel in which it trades. Downtrend support was close to parity, but now the road lower is open.

Lines

1.1130 is an old line dating from 2009. It is still high. 1.0850 capped the pair in 2009 and 2010 and remains of high importance.

1.0677 also worked as strong resistance for many days, and was tackled again in Q3 2011. The round number of 1.05 is now a top in the range and can be challenged in the near future.

The round number of 1.03 was a battle line, and it seems that the pair overcame it. The 2009 low of 1.02, another round number, returns to the limelight.

The ultimate line of USD/CAD returns to have a major role after working as support. 0.98 is an important cushion on the downside, where the pair bottomed out.

0.9667 is a pivotal line on the way down, after working as support. 0.9406 was the lowest post crisis level, and is the ultimate support line.

The 2007 of 0.9056 is way down.

For more on the Canadian dollar, see the **USD/CAD Weekly Outlook**.

Australian Dollar – Will the Aussie Remain Popular?

The Australian dollar is moving away from its "risk" status. This comes as the world is looking for good investments and doesn't see the euro and the A$ in the same light anymore.

Will this rally find a limit? The Aussie is enjoying some positive factors but not all is rosy down under:

- **Sound metrics**: With so much debt in Western countries, Australia's perfect AAA and low debt to GDP ratio of around 30% attract global flows looking for higher yields and safety.
- **German flows**: The Bundesbank announced that it is diversifying its currency holdings into the Australian dollar.
- **Swiss flows**: The SNB's peg to the euro raises its euro holdings. The Swiss central bank recently reported that while dollar, yen and pound holdings remained stable, it raised holdings of the Aussie.
- **Chinese Flows**: Australia's largest trade partner is apparently buying the debt of Australian states. The Chinese choice of state debt is quite surprising given the recent ratings pressure some Australian states are under.
- **Improving Economy**: Earlier in the year, it seemed that the mining sector is the only strong sector in Australia. With recent improvements in retail and construction, the picture looks a bit better.

On the downside, we have these factors:

- **Housing bubble**: There are more signs that Australia's housing sector is imploding. The real estate markets look like the US before the fall.

- **Low Inflation**: Recent inflation data shows a deceleration in price rises. This opens the door for more rate moves.
- **Strong currency can play against it**: Similar to New Zealand, the high value of the currency can encourage action from the RBA – not by intervention, but by a rate cut from the relatively active central bank.
- **Chinese slowdown**: China is landing. Australia isn't feeling it just yet, but negative headlines are a risk to the Aussie.

AUD/USD Technical Outlook

The Aussie continued making impressive gains for a second month in a row. It is now approaching higher resistance. Will it break higher?

Note that the pair now trades in an **uptrend, widening channel**, highlighted in the chart.

Lines

The float-era high of 1.1080 is the ultimate line high in the sky. It wasn't a swing high but rather a significant hurdle. 1.0850 was a double top at the beginning of the year and is now resistance on strong upside moves.

The round number of 1.06 worked as support during two periods when the Aussie was trading higher. 1.0480 provided support during 2011 and is now a significant line of struggle.

1.0230 proved to be a critical separator, working as support earlier in the year, as resistance later on and now as somewhat weaker support, backed by 1.02.

AUD/USD Parity is an important psychological line, although not so strong. 0.96 provided an important cushion in September 2011 and also in June 2012.

0.94 is an important trough and also the cap of a long term range that lasted in 2009-2010. The round number of 0.90 will is of psychological importance.

For more on the Aussie, see the **AUD/USD Weekly Outlook**.

New Zealand Dollar – Tendency to Lower Rates Might Rise

New Zealand still enjoys the surprisingly strong growth of the economy in Q1. The major domestic event in August will be the release of employment data, which is a quarterly figure in New Zealand, thus having a strong impact.

- **Sensitivity to high NZD**: The central bank, RBNZ, doesn't like strong exchange rate. It strongly expressed this sentiment in the last rate decision in which it kept the rates unchanged. The high value of NZD weighs on exports to Asia.
- **Low inflation**: Quarterly CPI figures came out lower than expected. This limited the kiwi's gains.
- **Diversification**: The Australian dollar enjoyed favorable flows from all over the world: Germany, Switzerland and China. For now, it seems that the kiwi is getting only a small portion of these flows. If the Aussie rises too high, a diversification into the kiwi.

- **Rate cut**: While an intervention to lower the value of the kiwi isn't on the cards, there is a small chance that the RBNZ will move to lower the rates sooner than later. A rate hike was discussed earlier in the year, but now inflation is significantly lower.

NZD/USD Technical Outlook

The kiwi had a rocky month, but ended it with a positive tone, even though the road was choppy and the gains smaller than beforehand.

Lines

The round number of 0.90 is in uncharted territory. The float-era high of 0.8842 is the ultimate resistance line.

0.8470 was the peak in 2012 and remains key resistance. 0.8242 capped the pair on the way up and remains important within the range trading.

0.8060 proved to be of high importance, working as support early in the year and afterwards switching to resistance. It remains key resistance. Under 0.80, the next round number of 0.79 is now pivotal, although weaker than beforehand.

0.7650 capped the pair on recovery attempts and also worked as resistance in 2009. 0.7450 was a stubborn bottom in May 2012 and was also a swing low in the fall of 2011.

0.7350 is significant on the downside. The pair got close to this line during Q4. The round number of 0.71 was a swing low in 2011 and a break lower would be a bearish signal. Under the round number of 0.70, the next line of support is 0.6815, which worked as such in early 2010.

For more on the kiwi, see the **NZD/USD Weekly Outlook**.

Relative Strength Index

July Revisited

This is how currencies moved in July:

1. **AUD**: AUD/USD rose by 2.6%.
2. **JPY**: USD/JPY fell by 2.2%.
3. **CAD**: USD/CAD fell by 2%.
4. **NZD**: NZD/USD rose by 1.1%.
5. **USD**
6. **GBP**: GBP/USD dropped by 5 pips.
7. **CHF**: USD/CHF rose by 2.9%.
8. **EUR**: EUR/USD fell by 2.9%.

The predictions were better than June, but not good as in May. I got the stability of cable the loonie's strength and the losing euro and franc, but underestimated the strength of the Aussie and the yen.

This was the speculation from the month of July:

1. **CAD** – The economy is relatively strong and proved it can absorb shocks in oil – Indeed, loonie showed strength thanks to a stronger economy and oil.

2. **USD** – can reverse some of the losses, assuming that trouble in the euro-zone will return. – Made gains only against the losers as the euro decoupled from risk currencies.
3. **GBP** – the Olympic games and safety from Europe can help the pound edge higher in the list. – Indeed, the pair eventually remained in the same spot.
4. **JPY** – the ultimate safe haven currency has some flaws, and could suffer from an intervention. No open intervention was seen, and USD/JPY slid slowly.
5. **AUD** – this risk currency will fall if Europe deteriorates. – The Aussie shifted to its own world and seems unstoppable.
6. **NZD** – the same as with the Aussie, just that NZD has more to lose after the big gains. – The kiwi was relatively resilient, but couldn't race the Aussie.
7. **CHF** – the effective peg to the euro will probably remain. – Indeed, the peg was solid rock, and the SNB keeps on collecting falling euros.
8. **EUR** – The European debt crisis is far from over, and the strong close of June means there's more room to fall. – Yup, a big loss indeed put the euro at the bottom.

July Predictions

It's important to stress that this outlook is not a trade recommendation, but just commentary. This will be revisited in the next monthly outlook.

There's a big debate about the EU Summit. The rally was strong and lasted longer than previous ones. However, immediate solutions are not in abundance. The following predictions are based on expectations that the gloom will somewhat return, and that the summit was NOT a game changer. This didn't work out in June, but could be seen in July.

So, shorting EUR/USD is the preferred trade? This yielded 877 pips in May, and the trend isn't over yet, unless, as aforementioned, magical central bank coordination does wonders. It can do wonders to stabilize the situation, but not necessarily the value of the euro.

Key Events

Here are the key events that are set to impact currencies all over the world, larger than the scope of any individual country.

- August 1st: US Rate Decision – 0 change in policy boosted the dollar but some still expect QE3.
- August 2nd: UK Rate decision – No change in policy.
- August 2nd: ECB Highly Anticipated decision – Draghi sets the ground for full QE, but provides conditions that disappoint markets. Spain is likely to comply.
- August 3rd: US Non-Farm Payrolls +163K, better than expected.
- August 6th: Australian rate decision
- August 6th: Swiss Currency Reserves – did the Euro long get much longer?
- August 8th: New Zealand Quarterly Employment Data
- August 9th: Japanese Rate decision
- August 9th: Australian employment data
- August 10th: Canadian employment data.
- August 14th: European GDP data – including a probable German contraction.
- August 15th: UK Inflation report – governor King ususally rocks the pound with his words.
- August 20th: Greece needs to pay over 3 billion euros to the ECB.
- August 21st: US FOMC Meeting Minutes – a hint towards the next move.
- August 22nd: Spanish 10 year bond auction
- August 23-24th: Jackson Hole Symposium – Bernanke might provide new hints there.
- August 29th: Italian 10 year bond auction
- August 29th: US GDP, second release.
- August 31st: Canadian GDP.

Sources for this report:

- Forex Factory Calendar

- FX Street Calendar (available on Forex Crunch).

Additional Notes for Forex Traders

Here are some additional notes for forex trading during this quarter.

Volume is Low

August is the ultimate month of vacations. Trading volumes are usually lower. This is seen in long hours of hardly any movement, and some wild jumps that don't last long. This is still not the peak of the summer, so there are enough hours with healthy liquidity and trading. Nevertheless, it's important to be aware of this.

Trade with care! High leverage and wide stops can be disastrous to your trading account. When volatility is higher, reduce position sizes and minimize your risk. Don't gamble.

Apart from looking how to win in trading, it's important to limit your risk. Here are three basic methods for this.

Choosing a More Predictable Pair

Some pairs follow the rules of technical analysis in a better way, while others are quite unpredictable. This depends a lot on your trading system and on your style and these patterns change all the time. Nevertheless, here is an updated list of the **5 Most Predictable Currency Pairs – Q3 2012**.

Resources

General Articles

- **5 Points on When to Go Pro** – Successful at forex trading and considering of doing it full time? There are a few steps on the way.
- **How to Choose a Forex Broker** – There are quite a few tools you can use before making this important decision.
- **How About Investing in Forex?** – Foreign exchange doesn't necessarily have to involve active trading, but can be
- **Risk Factor Explained** – A deeper explanation about why the dollar falls on good figures and vice versa and under what conditions this will end.

- **Trading in Range or Catching Breakouts?** – What is your style? And what to look out for.

Recommended Sites:

- **TradingNrg** – For all you need to know about gold, oil and other commodities.
- **BO Crunch** – All you need to know about trading binary options.
- **ForexStreet.Net** – A great forex social site where you can interact with others.
- **Forex Live** – For the fastest updates on the web.

That's it! As I've mentioned at the beginning, I welcome feedback, comments, suggestions, complaints and anything you wish to tell me about this report. Please send any feedback to yohay@forexcrunch.com.

Happy forex trading!